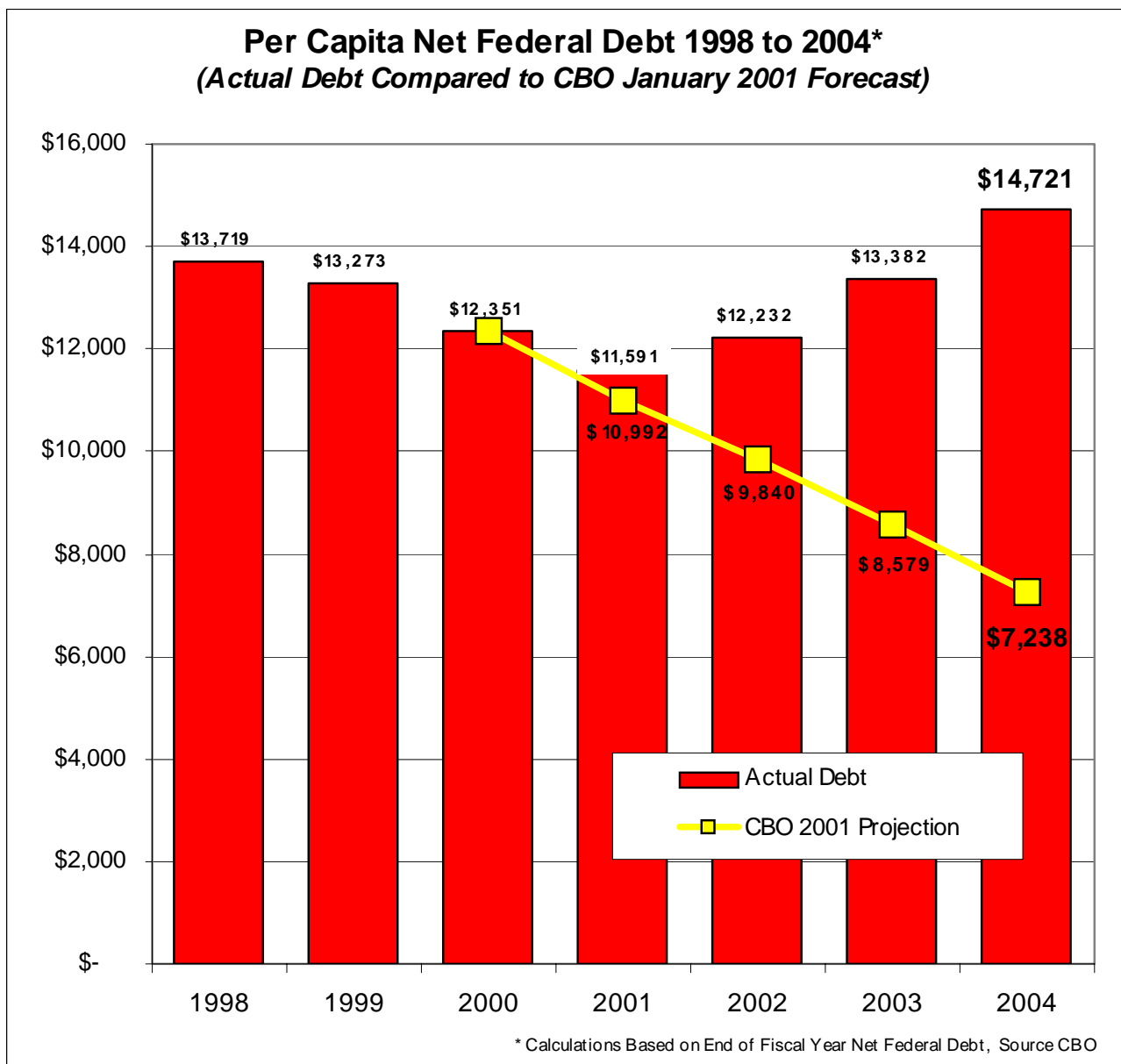


AN ANALYSIS OF THE RECENT DETERIORATION IN THE FISCAL CONDITION OF THE U.S. GOVERNMENT



by Scott Lilly, Senior Fellow

The Fiscal Deterioration of the Past Four Years Is Unprecedented in the Last Half Century

In early September, the Congressional Budget Office released its estimate of the fiscal 2004 federal budget deficit, indicating that government outlays would exceed revenues by a total of \$422 billion—the largest budget deficit in history. The fiscal '04 deficit exceeds the previous record, a \$375 billion deficit set just last year, by nearly 13 percent.

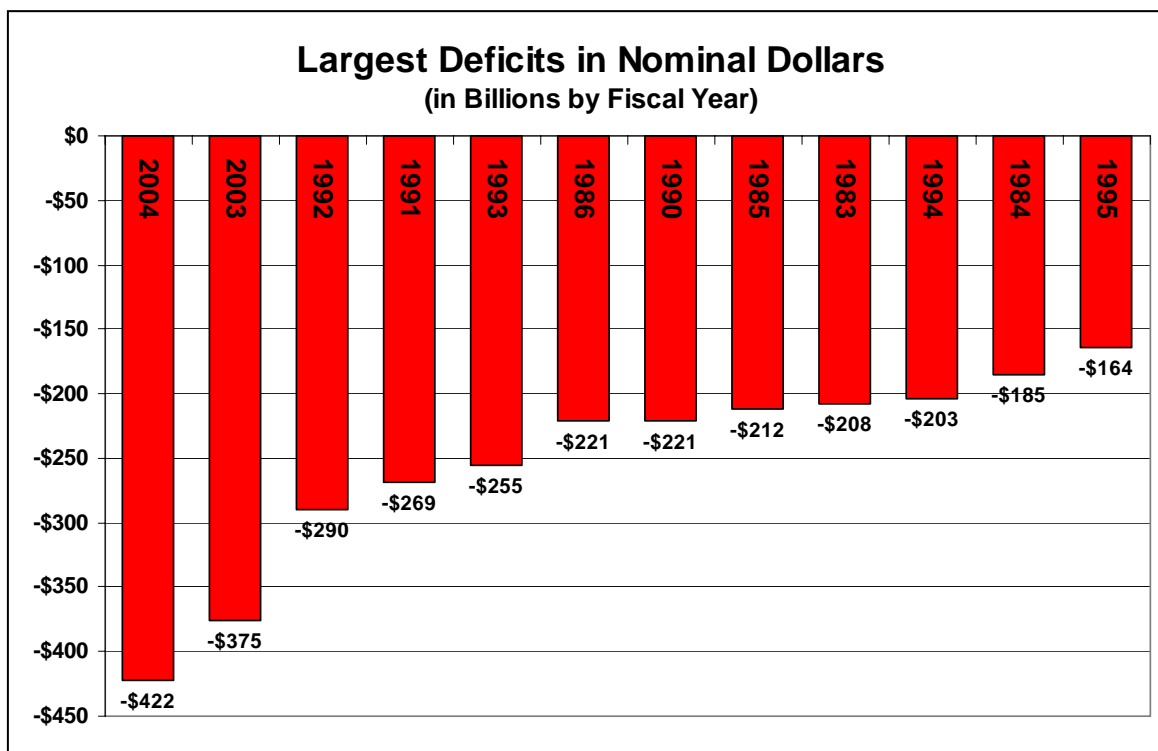
Even more striking than the size of these deficits is the speed with which the nation has developed them. As recently as fiscal 2001, the federal budget was still in surplus, and as recently as fiscal 2000, the nation had the largest budget surplus in its history.

The White House has argued that the

size of these deficits is far less dramatic when viewed in the context of the overall economy. The fiscal '04 deficit equals about 3.7 percent of GDP, smaller as a share of GDP than all four of the deficits generated during the first Bush administration, smaller than the deficits generated by five of the eight Reagan budgets and smaller than the fiscal 1976 deficit which occurred during the Ford administration. On the other hand, in raw numbers this year's deficit is larger—in fact, much larger than those generated in any of the other years of the last half century.

Speed of Fiscal Deterioration

That still leaves the question of whether the speed of this fiscal deterioration has



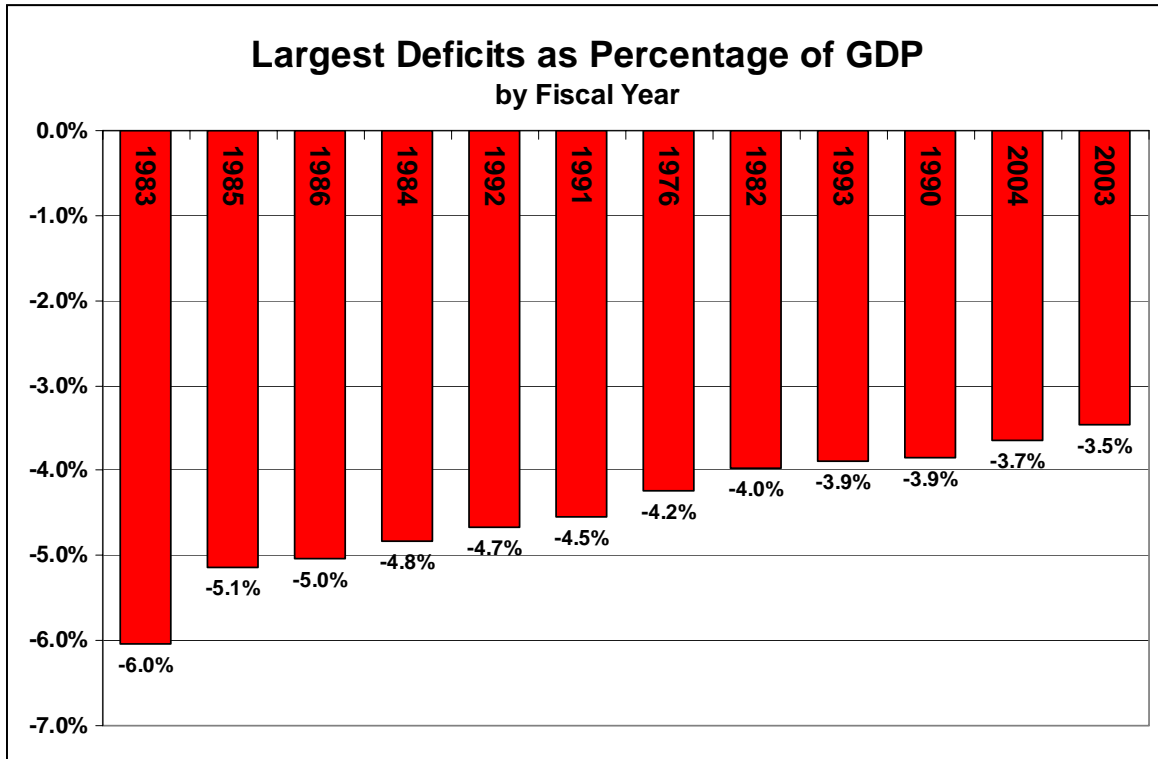
a modern precedent. If we measure surpluses and deficits as a percentage of GDP and look at the improvement or deterioration during four-year periods over the last 50 years, does the change that has occurred over the past four years break previous records? The answer to that question is yes.

The \$236 billion surplus which the United States enjoyed in fiscal 2000 equaled 2.4 percent of GDP for that year. The \$422 billion deficit this year equals 3.7 percent, which creates an overall swing in the nation's fiscal well being of 6.1 percent in a four-year period. If fiscal 2003 is excluded (the deterioration from fiscal 1999 to fiscal 2003 equaled 4.9 percent) the worst period of fiscal deterioration was between fiscal 1979 and fiscal 1983, when deficits as a percentage of GDP grew from 1.6 percent to 6.0 percent for

a 4.4 percent deterioration over a four-year period. That means that the decline that has occurred in the nation's fiscal well being over the past four years is not only larger than in any previous period in the past half century, but about 40 percent bigger than the next worst period.

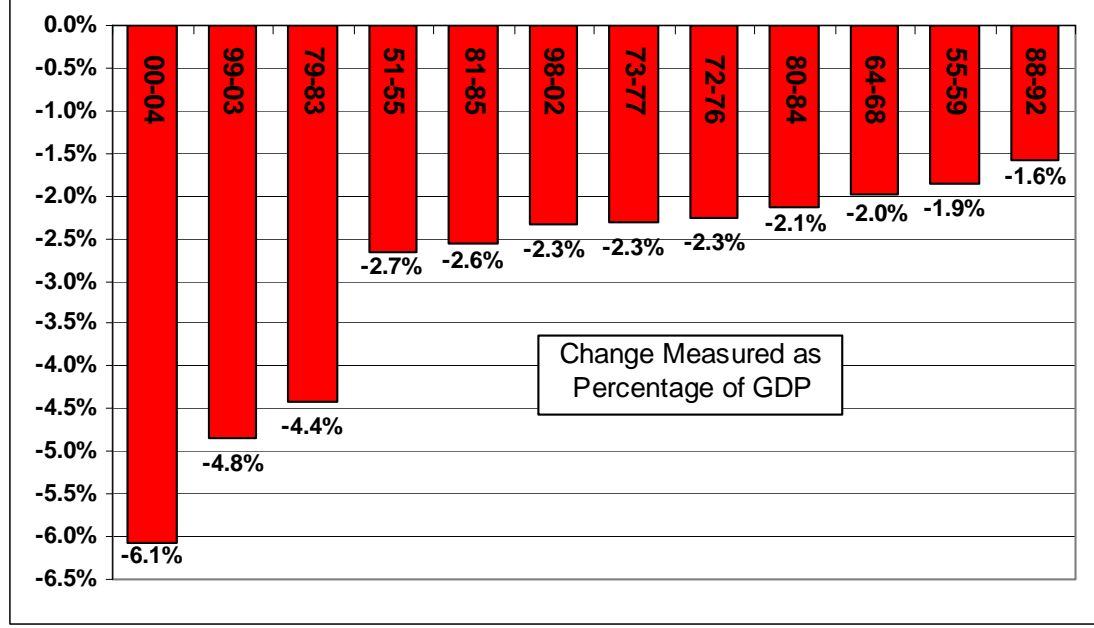
The most improvement during a four-year period occurred between fiscal years 1996 and 2000, when the nation went from a 1.4 percent deficit to a 2.4 percent surplus, although the period 1994 to 1998 was almost as good when we went from a 2.9 percent deficit to a 0.8 percent surplus.

Shifts of this magnitude did not take place at any other time during the 50-year period. Other than the previously mentioned period from 1979 to 1983, there is no four-year period prior to the past ten years with a shift of as much as



Periods of Greatest Decline in Federal Government's Ability to Pay its Bills

(Decline in Surplus/Increase in Deficit Over 4 Year Periods during Past Half Century)



3 percent, and in a large majority of the four-year periods examined, the shift was less than 2 percent.

That presents the question as to why the fiscal condition of the country changed so much more rapidly during the past four years than at any other period during the past 50 years. There are four major factors that can impact on the size of budget deficits, economic growth, inflation, interest rates and government policy.

Economic Factors Offset One Another in Their Impact on Federal Budget

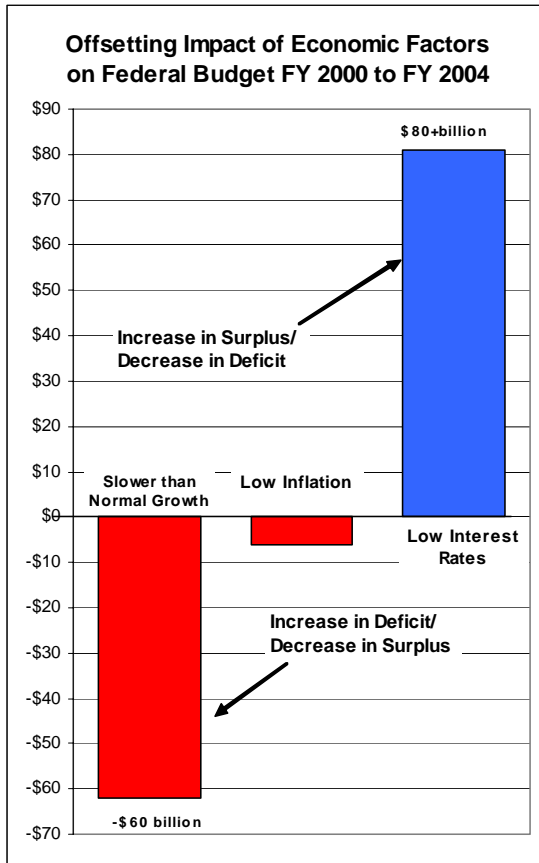
Growth

Over the past 50 years, the average annual rate of real economic growth has been about 3.4 percent. Since 2000, the average rate of growth has been 2.6 percent. Had GDP grown at the average rate between 2000 and 2004, the U.S. economy would have been more than 3

percent, or about \$385 billion larger, than it is today. Since the federal government now collects about 16.2 percent of GDP in taxes, the impact of a more normal rate of growth would have been to cut about \$62 billion from the deficit. That would have cut this year's deficit to \$360 billion and reduced the percentage change in the fiscal well being of the government from a decline of 6.1 percent to a decline of 5.6 percent, still dramatically greater than any other four-year period in the past half century.

Inflation

Inflation affects the budget in two ways. Higher levels of inflation create more nominal income and increase government revenue collections. Simultaneously, mandatory programs such as Social Security and Military Retirement are indexed to increases in inflation, and so outlays for such programs increase. Other federal



activities that are not legally indexed, such as civilian and military pay, are also affected. In 2001, CBO estimated that an increase in the rate of inflation of one percentage point for a period of four years would increase revenues in the fourth year by \$26 billion more than it would increase outlays.

Inflation has fluctuated greatly over the last 50 years. During the last 10 years, it has stabilized in the 2 percent to 2.5 percent range. Inflation over the last four years has been slightly lower (about 0.2 percent per year) than in the previous four years. If the CBO estimate on the impact of inflation on the budget is correct, the lower pace of inflation since 2000 added \$6 billion to the 2004 deficit.

Interest Rates

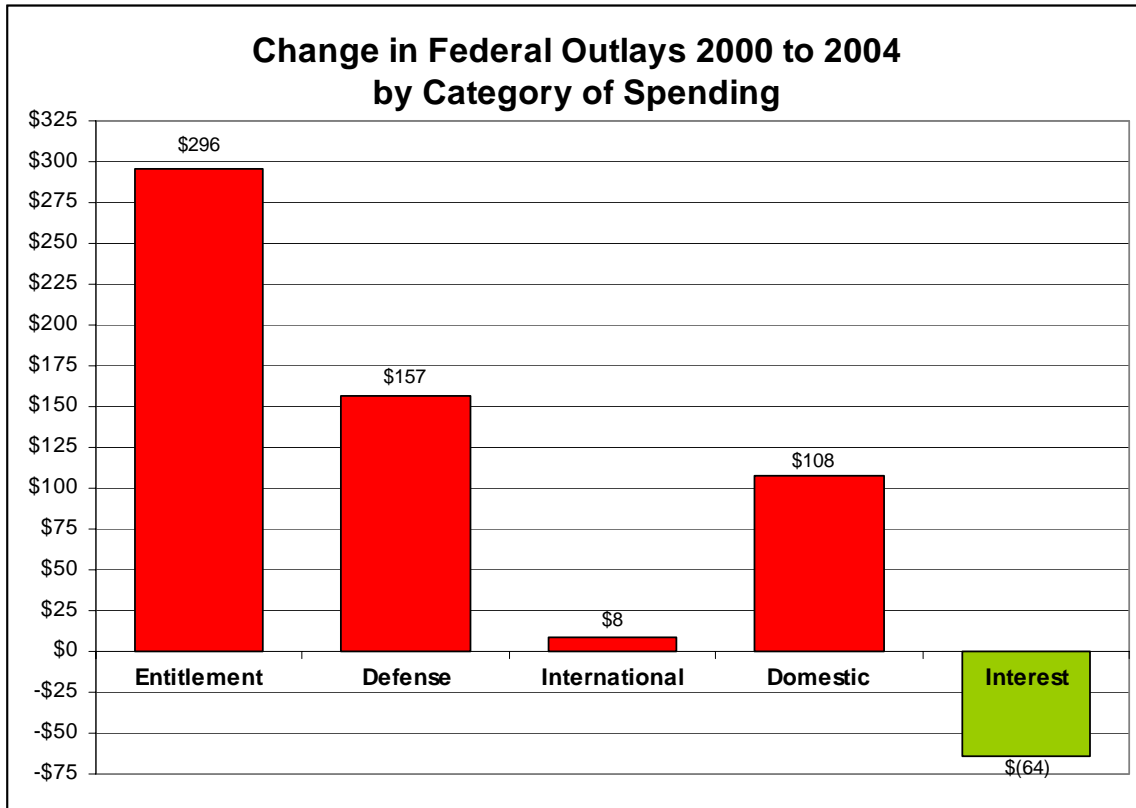
Changes in interest rates can significantly affect the cost of federal debt service, although rising or falling rates do not fully impact government interest payments immediately. This is because much of the debt is held in longer term notes and bonds.

Interest rates over the past four years have been significantly below the levels of the previous four years—in part because of the weakness of the economy. Short term treasuries (90 day and 6 month T bills) have dropped from 5.1 percent yields in the 1997 to 2000 period to an average of less than 2 percent in the 2001 to 2004 period—a more than 3.0 point difference.

In fiscal 2000, interest on the net public debt (government debt not held by government trust funds) totaled \$233 billion. Since then the debt has risen by \$924 billion, or 27 percent. Interest payments on that larger debt would have totaled well over \$250 billion in fiscal 2004 had interest rates remained at 2000 levels. (A precise calculation is difficult because it requires precise data on the amount of long term debt that has turned over during that period and the interest rates that were paid on that debt.) Instead of rising by more than \$17 billion, interest payments on the public debt fell by \$64 billion between fiscal 2000 and fiscal 2004. As a result, lower interest rates saved the government well over \$80 billion in 2004.

2004 Deficit Lowered by Economic Conditions

The approximately \$62 billion lost in revenues because of slower economic growth and the approximately \$6 billion lost because of low inflation were more than offset by the effect that slow growth



had on the interests payment by the federal government.

The bottom line is that the three major economic factors that influence federal deficits largely canceled each other out and in total, economic factors had little impact on the government's fiscal reversal that took place during this period. The deterioration that occurred appears to be almost entirely attributable to government policy.

**Policies that Contributed to
Fiscal Deterioration**

There are three basic components to federal budgets:

(1) Spending that is fixed by permanent law to assist particular designated recipients such as military retirees or state Medicaid programs, often referred to as "entitlement spending."

(2) Spending that is determined each year to carry out the various activities of

the government, often described as discretionary spending.

(3) The laws that govern the taxes and other forms of revenues that are paid each year to the federal government.

An analysis of all three of these policy areas indicates that each has contributed, at least to some extent, to the deterioration of the nation's fiscal condition.

Between fiscal 2000 and fiscal 2004, total federal outlays grew by \$504 billion, or 28 percent. Since prices rose by about 9 percent over that period, real or inflation-adjusted spending growth totaled 19 percent. Federal spending grew about 12 percent faster than the economy was growing.

Entitlements

Both entitlement and discretionary spending contributed to the pace of

spending growth. Entitlement expenditures grew by \$291 billion, or by 31 percent, over the four-year period. Nearly half (47 percent) of that growth was attributable to just two programs, Medicare and Medicaid. In total Medicare and Medicaid expenditures were 42 percent higher in fiscal 2004 than they had been in fiscal 2000. Among the factors driving the increased outlays in these programs was the continued high inflation in health care costs and aging of the population.

Discretionary Programs

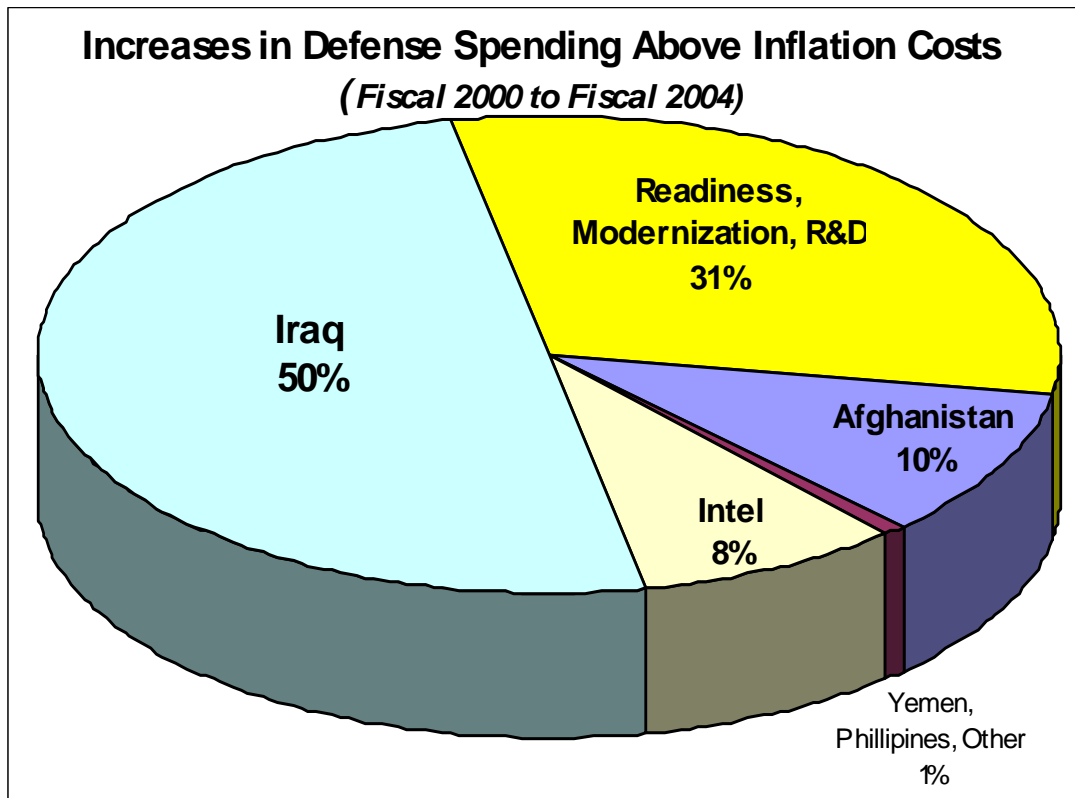
Discretionary spending grew even more rapidly over the four-year period. In total, discretionary outlays were \$273 billion, or 44 percent higher in fiscal 2004 than they had been in fiscal 2000. The big factor in the growth of discretionary spending was the very rapid growth in Defense outlays which increased from a level of \$295 billion in

fiscal 2000 to a level of \$452 billion in fiscal 2004—an increase of \$157 billion, or 53 percent.

Approximately \$37 billion of the \$157 billion is the result of increased pay and benefits for military and civilian personnel at the Department of Defense, increased fuel costs and inflation in other purchases required to simply maintain our military forces at fiscal year 2000 levels. Particularly important among these has been the expansion of military health benefits and the increase in military health costs.

Administration budget documents attribute most of the remainder of the increase to activities related to the war on terror. The extent to which that is true depends on what is counted in the war on terror.

Nearly everyone would agree that the U.S.-led effort against the Taliban and al Qaeda in Afghanistan would fall into



that category. Throughout fiscal 2004, U.S. military expenditure in Afghanistan averaged about \$900 million per month or about \$11 billion a year. Efforts in support of the Afghan operation may have totaled several billion more. Smaller U.S. military efforts in places across the globe (Yemen, the Philippines and so forth) may have made important contributions to the war on terror, but accounted for well under a billion in fiscal 2004 expenditures.

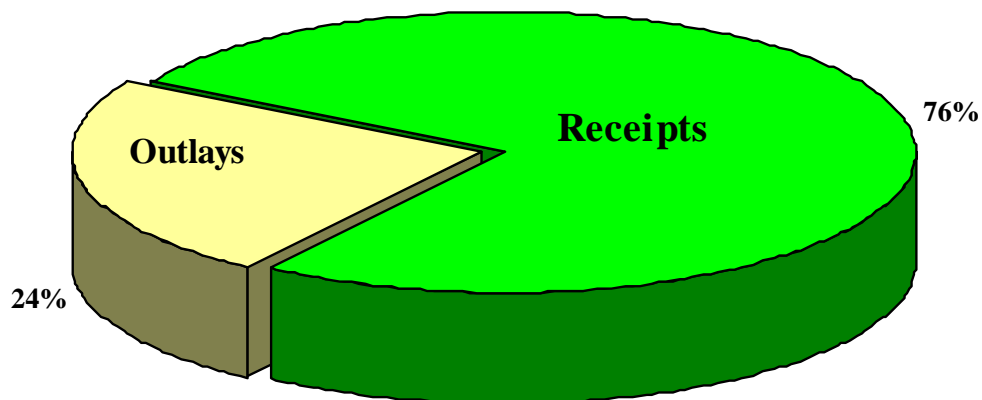
Much of the intelligence budget is contained in Department of Defense Appropriations. There have undoubtedly been substantial increases in U.S. intelligence efforts and a very large portion of those increases are associated with global efforts against terror. The size of the intelligence budget and the amount it has increased in recent years is classified. It would be reasonable to assume, however, that the increases directly associated with the war on terror do not significantly exceed \$10 billion.

That leaves about \$100 billion, or more

than 80 percent of the increase, not associated with cost of living adjustments to other activities and programs—the largest of which, the war in Iraq, may or may not be associated with the war on terror depending on your point of view.

The incremental cost of Iraq is about \$4 billion a month in direct operations. In addition, support costs are estimated to be in the neighborhood of \$1 billion a month, leaving annual expenditures in the neighborhood of \$60 billion. That does not include the ongoing cost of maintaining the military units that are there or training to go there—only the additional costs of transporting and maintaining those forces in a combat zone and the operational costs in excess of normal training and equipment use. The extent to which the duties of U.S. military forces have been dominated by the Iraq deployment is illustrated by the fact that by the end of the first year of the deployment, an estimated 80 percent of all equipment in the U.S. Army

What Caused the Fiscal Reversal?



If receipts and outlays had kept pace with the economy, we would have collected \$538 billion more in revenue, spent \$168 billion less from the Treasury and enjoyed a \$281 billion surplus. Debt would have been below CBO projection.

inventory was either in Iraq or had been there.

Foreign Assistance

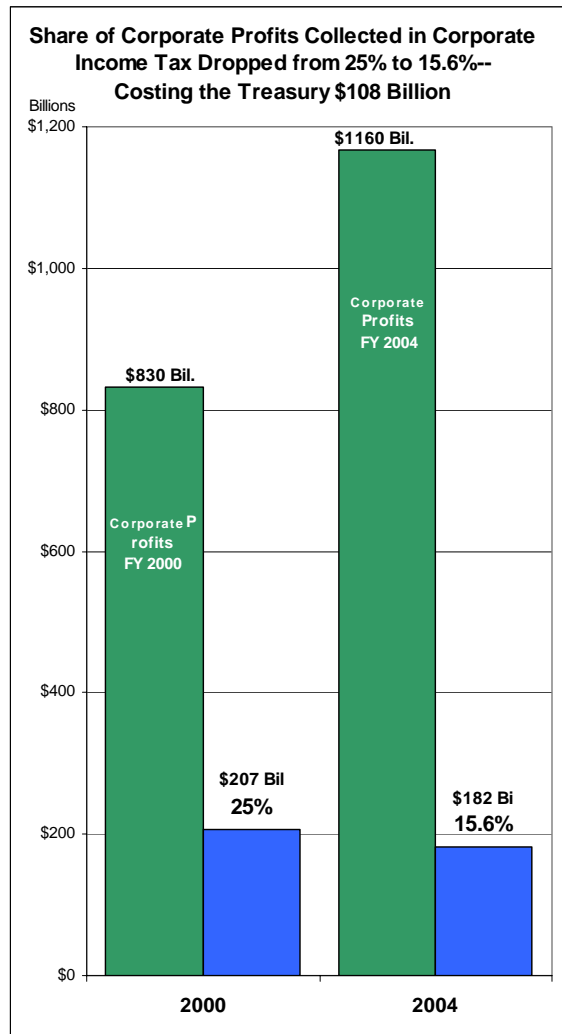
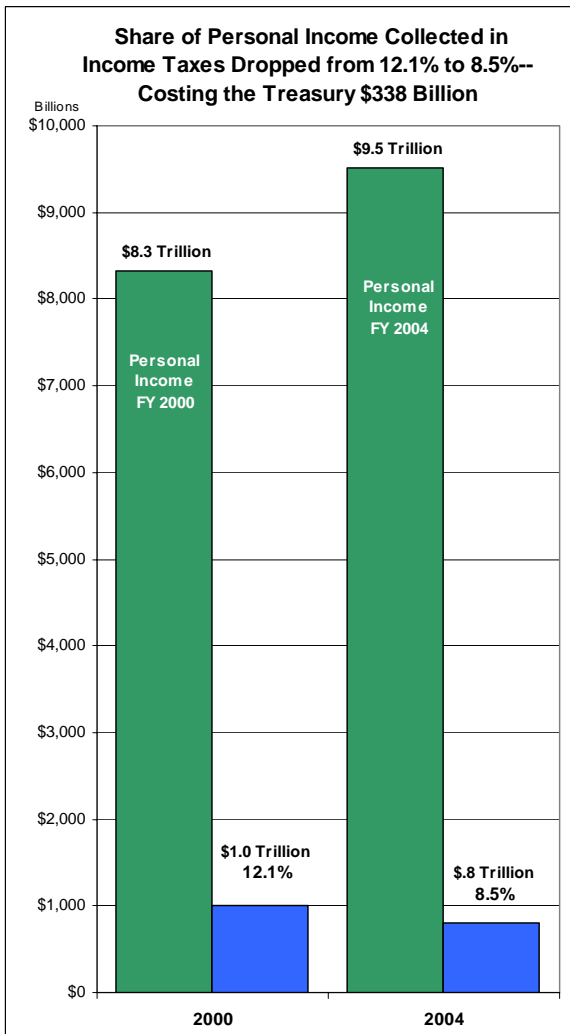
In addition to the increase in Defense spending there was also a large percentage increase in foreign aid and other non-military foreign activities of the federal government. This area of activity grew by \$8.2 billion or 39 percent and would have grown by more than 50 percent over the period if the security situation in Iraq had not inhibited the ability of USAID and its contractors to undertake infrastructure and training projects that had been planned during fiscal 2004.

Domestic Discretionary

Domestic discretionary programs also grew by a significant amount. Outlays for these programs increased by \$108 billion or by 36 percent during the period. Increases in law enforcement and homeland security accounted for a portion of these increases, but the vast majority of the growth occurred in other areas of the domestic budget.

Total Spending Growth

Overall, spending grew from 18.4 percent of GDP in fiscal 2000 to 19.8 percent in 2004. As substantial as that growth was, the federal budget would have run a surplus in fiscal 2004 if it had



continued to collect the same share of GDP in revenue. Fiscal 2004 expenditures of \$2,293 billion would have been offset by revenues of \$2,409 billion if the federal government had collected 20.8 percent of GDP in revenues as it did in fiscal 2000. This would have left a surplus of about \$116 billion or 1 percent of GDP. That would have been a deterioration of 1.4 percent, rather than the 6.1 percent deterioration that was experienced.

Revenue

That means that more than three quarters of the deterioration that occurred is attributable to tax policy. During a period (fiscal 2000 to fiscal 2004) in which personal income grew from \$8.3 trillion to \$9.5 trillion, the money collected in individual income tax declined by \$190 billion, or more than 19 percent. Corporate income tax declined by \$25 billion, or 12.5 percent, despite the fact that corporate profit rose during the period from \$835 billion to \$1165 billion, an increase of \$330 billion, or almost 40 percent. Estate and gift taxes declined by \$7 billion, or 24 percent. Not all tax collections declined over the period. Payroll or Social Insurance tax collections grew by \$79 billion, or 12 percent. Overall, however, federal tax collection declined from 20.8

percent of GDP in fiscal 2000 to 16.2 percent of GDP in 2004.

Implications for Public Debt

As recently as the winter of 2001, mainstream budget forecasters were predicting based on current trends that the public debt—which at that time totaled nearly \$3.4 trillion—would be eliminated sometime during the decade of 2010 to 2020. In its January forecast in 2001, CBO predicted that under current policies the debt would drop to \$2.1 trillion by the end of this fiscal year. On a per capita basis that meant that public debt would equal about \$7,238 per individual. CBO now reports that the public debt actually rose to \$4.3 trillion, or on a per capita basis \$14,721—more than twice the projection of just three-and-a-half years ago.

A household of four people would collectively be responsible for nearly \$30,000 more debt than CBO had predicted. While most households benefited from the spending and tax policies that led to the reversal in the government's fiscal condition, there is probably only a small percentage that benefited sufficiently to feel comfortable with the additional debt for which each household is now responsible.

* The vast majority of data in this report is derived from [Appendix F](#) of the Congressional Budget Office publication *The Budget and Economic Outlook: Fiscal Years 2005-2014*, combined with the Projections for fiscal year 2004 contained in the [The Budget and Economic Outlook: An Update](#). (September 2004) also published by the Congressional Budget Office. Estimates of per capita debt are derived from Census Bureau data from which an estimate of average U.S. population during the fiscal years 2000 and 2004 were derived. Data regarding factors driving the increase in Defense expenditures was estimated by the author based on information contained in the [National Defense Budget Estimates for the FY 2004 Budget \(Green Book\)](#), information provided by the Minority Staff of the House Appropriations Committee and information contained in the publication [Growth in Medical Spending by the Department of Defense](#), (September 2003) by the Congressional Budget Office. Personal income and corporate profit data is from the Commerce Department's National Income and Product Accounts. The Fiscal 2004 estimates were derived by averaging the annualized rates for the 1st and 2nd Quarters of calendar 2004 which would be the middle two quarters of fiscal 2004.

Fifty Years of U.S. Government Finance

(In Millions of U.S. Dollars)

Fiscal Year	Receipts	Outlays	Surplus or Deficit(-)	Debt Held by Public	GDP	Deficit as % of GDP	Improvement in Fiscal Balance (as % of GDP) Compared to 4 Years Earlier
1955	65,451	68,444	-2,993	226,616	395,200	-0.76%	-2.66%
1956	74,587	70,640	3,947	222,156	427,700	0.92%	1.36%
1957	79,990	76,578	3,412	219,320	450,700	0.76%	2.50%
1958	79,636	82,405	-2,769	226,336	461,100	-0.60%	-0.30%
1959	79,249	92,098	-12,849	234,701	492,100	-2.61%	-1.85%
1960	92,492	92,191	301	236,840	518,900	0.06%	-0.86%
1961	94,388	97,723	-3,335	238,357	531,800	-0.63%	-1.38%
1962	99,676	106,821	-7,146	248,010	568,500	-1.26%	-0.66%
1963	106,560	111,316	-4,756	253,978	599,700	-0.79%	1.82%
1964	112,613	118,528	-5,915	256,849	641,300	-0.92%	-0.98%
1965	116,817	118,228	-1,411	260,778	687,900	-0.21%	0.42%
1966	130,835	134,532	-3,698	263,714	754,200	-0.49%	0.77%
1967	148,822	157,464	-8,643	266,626	813,500	-1.06%	-0.27%
1968	152,973	178,134	-25,161	289,545	868,400	-2.90%	-1.98%
1969	186,882	183,640	3,242	278,108	949,200	0.34%	0.55%
1970	192,807	195,649	-2,842	283,198	1,013,200	-0.28%	0.21%
1971	187,139	210,172	-23,033	303,037	1,081,400	-2.13%	-1.07%
1972	207,309	230,681	-23,373	322,377	1,181,500	-1.98%	0.92%
1973	230,799	245,707	-14,908	340,910	1,308,100	-1.14%	-1.48%
1974	263,224	269,359	-6,135	343,699	1,442,100	-0.43%	-0.14%
1975	279,090	332,332	-53,242	394,700	1,559,800	-3.41%	-1.28%
1976	298,060	371,792	-73,732	477,404	1,736,700	-4.25%	-2.27%
TQ	81,232	95,975	-14,744	495,509	454,800	-3.24%	-2.10%
1977	355,559	409,218	-53,659	549,104	1,971,300	-2.72%	-2.30%
1978	399,561	458,746	-59,185	607,126	2,218,600	-2.67%	0.75%
1979	463,302	504,028	-40,726	640,306	2,503,800	-1.63%	2.62%
1980	517,112	590,941	-73,830	711,923	2,732,100	-2.70%	0.54%
1981	599,272	678,241	-78,968	789,410	3,061,600	-2.58%	0.14%
1982	617,766	745,743	-127,977	924,575	3,228,600	-3.96%	-1.30%
1983	600,562	808,364	-207,802	1,137,268	3,440,500	-6.04%	-4.41%
1984	666,486	851,853	-185,367	1,306,975	3,839,400	-4.83%	-2.13%
1985	734,088	946,396	-212,308	1,507,260	4,136,600	-5.13%	-2.55%
1986	769,215	990,430	-221,215	1,740,623	4,401,400	-5.03%	-1.06%
1987	854,353	1,004,082	-149,728	1,889,753	4,647,000	-3.22%	2.82%
1988	909,303	1,064,455	-155,152	2,051,616	5,014,700	-3.09%	1.73%
1989	991,190	1,143,646	-152,456	2,190,716	5,405,500	-2.82%	2.31%
1990	1,031,969	1,253,165	-221,195	2,411,558	5,735,600	-3.86%	1.17%
1991	1,055,041	1,324,369	-269,328	2,688,999	5,930,400	-4.54%	-1.32%
1992	1,091,279	1,381,655	-290,376	2,999,737	6,218,600	-4.67%	-1.58%
1993	1,154,401	1,409,489	-255,087	3,248,396	6,558,400	-3.89%	-1.07%
1994	1,258,627	1,461,877	-203,250	3,433,065	6,944,600	-2.93%	0.93%
1995	1,351,830	1,515,802	-163,972	3,604,378	7,324,000	-2.24%	2.30%
1996	1,453,062	1,560,535	-107,473	3,734,073	7,694,600	-1.40%	3.27%
1997	1,579,292	1,601,250	-21,958	3,772,344	8,185,200	-0.27%	3.62%
1998	1,721,798	1,652,585	69,213	3,721,099	8,663,900	0.80%	3.73%
1999	1,827,454	1,701,891	125,563	3,632,363	9,137,700	1.37%	3.61%
2000	2,025,218	1,788,773	236,445	3,409,804	9,718,800	2.43%	3.83%
2001	1,991,194	1,863,770	127,424	3,319,615	10,021,500	1.27%	1.54%
2002	1,853,173	2,010,970	-157,797	3,540,427	10,336,600	-1.53%	-2.33%
2003	1,782,342	2,157,637	-375,295	3,913,600	10,841,000	-3.46%	-4.84%
2004	1,871,000	2,293,000	-422,000	4,334,000	11,559,000	-3.65%	-6.08%

Source: "Historical Tables" of the Congressional Budget Office
The Budget and Economic Outlook, an Update September 2004